RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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THE MARKET: Over the years I've found that the single hardest concept to get across to readers is that the market can discount, that it can look ahead. I don't know why it's so difficult to convince people of the market's forecasting ability. Maybe the whole idea comes as a blow to our egos.

It is said that in history there have been three great shocks to man's ego. The first (from Darwin) was the thesis that man is descended from the lower animals on the evolutionary scale ("What, me descended from a lousy ape!"). The second shock (from Copernicus) was that the earth is not the center of the universe, but that the earth is just one of a number of planets that all revolve around the sun ("Are you kidding; the earth is the core, the center of the world!"). The third blow to man's ego (courtesy of Freud) was that we are not total masters of our own thoughts and actions, but that our unconscious often rules our lives ("What unconscious? What am I, some kind of a mind-slave?").

So maybe, taking that all into consideration, we can see why most people find it almost impossible to accept the premise that the stock market can look ahead -- that the market can SEE WHAT YOU AND I CANNOT SEE. Yet a study of history demonstrates that time and time again the market is able to discount events which we not only fail to see -- but events that we would deny even if we were somehow able to envision them.

What am I leading up to? Simply this: pick up any newspaper, look at any TV news program, read any financial magazine, and what do you see? Gloom and doom. And rightly so, because let's face it, today's business and financial news is an endless litany of gloom and doom. From Bank of America to IBM to real estate in Texas to chips in Silicon Valley, the news is all one color -- and the color is black. To illustrate (since I love to cut and paste), I put together this montage, all from recent issues of US News & World Report, Forbes and Business Week.

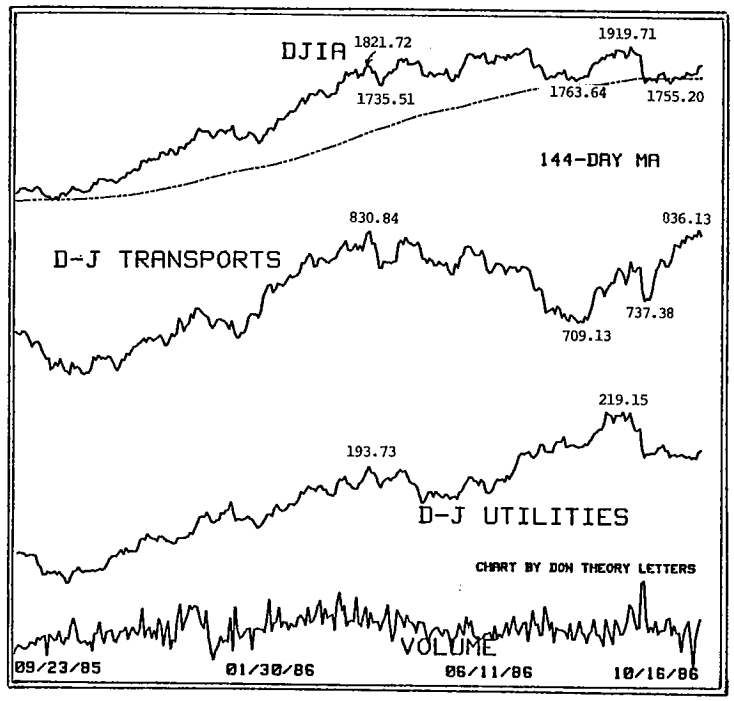
REAGANOMICS UNDER FOREIGN FIRE
Fixing responsibility for the slowdown in world trade is of consuming concern to bankers and government officials of the
MORE PAIN FOR MAKERS OF MACHINE TOOLS
EVEN HOMEBUILDING LOOKS WEAK
Uncertainty about tax reform has hit with a vengeance
FOREIGN PRODUCERS ARE CUTTING PRICES
No wonder Wall Street is confused
SHRINKING MARKETS FOR U.S. GOODS
Developing-country markets have slumped in large part because more and more resources are being used to meet debt payments. Despite the steep fall of the dollar, the U.S. trade deficit is so bad and exports
A downturn is inevitable, but it needn't be severe
DEBT, DEBT AND MORE DEBT
SLOW GROWTH —AND SIGNS OF TROUBLE EVERYWHERE

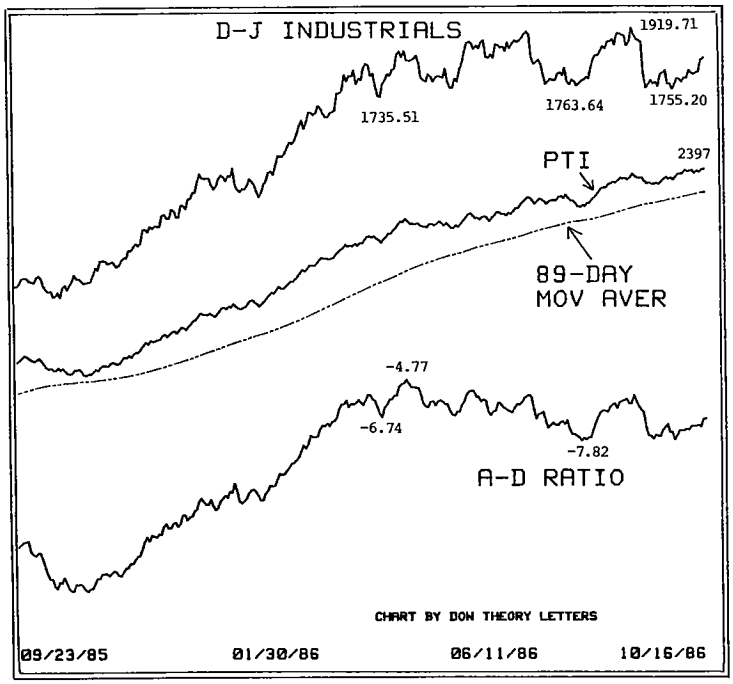
"So what is the stock market doing, holding together the way it is?" My answer is this: I don't use a crystal ball, but I do know how to read the market averages. Right now the Dow Theory is saying that despite all the rotten news, Wall Street remains in the grip of a primary bull market. The major trend of the market (although held back since March 1986 when the A-D peaked) is still UP.

"Russell, how do you know it's still a bull market?" I know because with all the bad news, the D-J Transportation Average has stubbornly and persistently refused to give its half of a bear signal. True, the D-J Industrial Average broke below its 1763.64 bear signal level, but the Transports not only refused to confirm, they never even got close to their own bear signal level of 709.13. And as I have stated many times, as far as the Dow Theory is concerned, half a bear signal is no better than none!

Now here's another interesting consideration which nobody seems to have noticed or written about. The advance-decline ratio (which is a proxy for all the stocks on the NYSE) topped out on March 31, 1986 (see page 2 chart). Almost seven months have elapsed since then, and in all that time (amid all the black news) the A-D ratio has given up only three points. Considering that March 31 represented the high for the majority of NYSE issues (as identified by the A-D peak), three points is very little to lose over a period of almost seven months in what some claim is "a bear market".

In comparison, from its1962 peak the A-D lost 12 points during the first seven months of the decline. In 1969, the A-D again lost 12 points during the first seven months of that decline. In 1973 the A-D lost 15 points during the first seven months of decline. In both 1982 and 1984 the loss was 9 points. So the 3 points lost





during the seven months of decline here in 1986 is very minimal. In fact, it is extraordinarily mild, considering the bearish nature of the business and economic news which has been emerging.

So there's little sense (although I read about it daily) in predicting a stock market collapse or a wave of doom that is fated to sweep over Wall Street. It will serve us far better if we simply watch the A-D ratio, my PTI and perhaps above all if we watch that 709.13 level on the D-J Transportation Average.

Remember this: The readings of the stock market barometer are the MOST SIGNIFICANT WHEN THEY DIFFER FROM THE PREVAILING NEWS AND FROM THE STANDARD ECONOMIC FORECASTS. Sure the A-D ratio could suddenly fall apart. Sure my PTI could start sliding down hill. And sure, the D-J Transports could collapse over the next month or so. But none of that has happened so far, despite the unabated stream of discouraging business news. So we can take the stance that either (1) the stock market indices will realize their mistake and get in gear with the news, or (2) that the stock market is discounting something ahead (something encouraging) that is not now obvious to the newspapers or the economic experts. As for me, I'll stick with choice number two, along with the concept that "the trend remains in force until proved otherwise."

Question: On October 15 the D-J Transportation Average closed at a new record high of 836.13. But on the same day the Dow closed at 1831.69, well below its record high of 1919.71. What's the meaning of this action?

Answer: The Dow hit its 1919.71 record high on September 4. Should we call the October 15 record Transport high a belated confirmation of the September high? As a rule, the longer the lag time of a confirmation, the less the validity of that confirmation. Since the record Transport high came six weeks after the record Dow high, I do not attach too much significance to it. The two Averages have been playing a game of "now you see a new bull market high, now you don't" which is OK but a bit frustrating.

The most powerful moves in a bull market come when both Industrials and Transports break out to new bull market highs simultaneously or perhaps a day or two apart. In due time we will see such action again. Right now I take the market action to be bullish but bullish within the context of a continuing mild correction. Personally, I have been buying a few higher yielding utility issues during this period of indecision.

Question: Russell, looking at the big picture, following the massive rise from the 1984 lows, the market has been in a high-level consolidation. This sideways movement has been going on since the end of March. What do you make of it?

Answer: After a major rise, a very STRONG stock market, instead of correcting, will occasionally consolidate or form a "line" at a very high level. I believe that is what we have been seeing since last March. If this is true, the next major market move should be out of the trading range and to the upside. It appears increasingly as if that is what we are fated to see somewhere in the period ahead.

INVESTMENT POSITION: Some of the bearish investment advisors are beginning to have second thoughts (and sweaty palms) as this market refuses to collapse under the barrage of poor business news. And clients who have sold out on the basis of bearish investment advice are beginning to wonder if they have not been "had." The current trading range, the huge and growing short position, and the stubbornness of this market in not collapsing, will, in due time, wear out the bears. When that happens, the vast majority of stocks will begin moving up again.

The best policy in a bull market (and this is a bull market) is to sit with a portfolio of good, dividend-paying stocks (plus good, quality bonds) and simply let the bull market do what it does best -- which is manufacturing profits. That's the policy I have been advising, and that's the policy I continue to advise. I have also advised buying a fixed amount of gold coins each month (whatever you can afford; I don't care if it's one or one hundred).

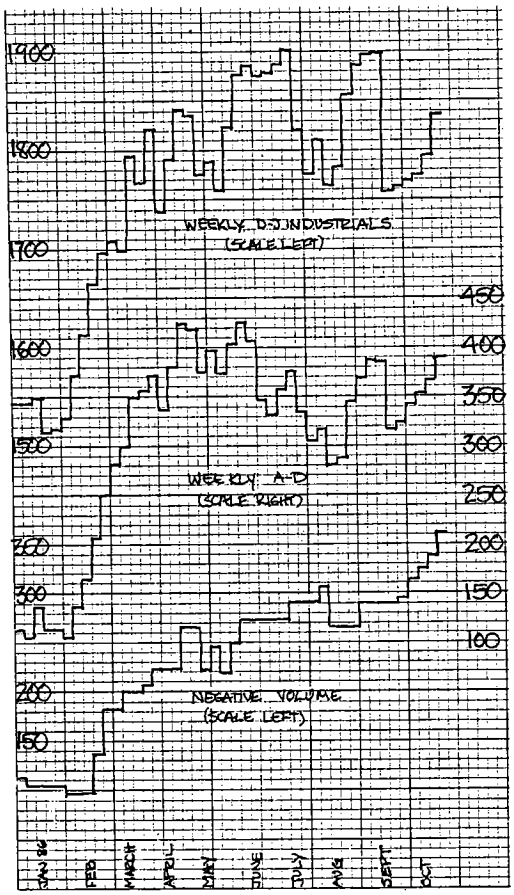
By the way, I can tell that our investment position policy has been working. I can also tell that subscribers have been pleased with their portfolios, even though we have been going through a corrective period in this bull market. How can I tell? I can tell by the rising level of subscriptions at this office.

EXTRAORDINARY NEGATIVE VOLUME ACTION: For 25 years I have been tracking an indicator which (for some unknown reason) very few other analysts know about or follow. I am referring to the negative volume index (NVI). This is an index which traces the advance-decline DIFFERENTIALS, but it traces the differentials only on days when exchange volume is BELOW the volume of the preceding day. The NVI can be computed on a daily basis or on a weekly basis, but of course it is easier to compute this index using the weekly figures. If any week's total volume is below the previous week's total volume then the NVI figure is entered (if the week's volume is greater than the preceding week's volume then no NVI computation is made, and that week's NVI remains the same as the previous week's). The NVI figures are added (or subtracted) to a running total.

The rationale for the NVI is this: Informed investors prefer to do their buying when the market is CALM (i.e., declining volume) whereas the public tends to do its buying during periods of EXCITEMENT (i.e., rising volume). Since informed buying (which tends to be the powerful buying) sets the underlying trend of the market, it is the informed buying that we want to track. This is exactly what the NVI does.

There is a normal tendency over the years for the NVI to decline, since normally stocks tend to rise on expanding volume and decline on contracting volume. But occasionally we will see an extended period when the NVI rises. Such periods are VERY RARE, and for this reason they command my attention.

Norman Fosback in his landmark book, "Market Logic", notes that "the NVI is an excellent indicator of the primary trend of the market. More particularly, it is one of the best bull market indicators in existence." In the course of his research, Fosback took the NVI back 35 years, and he found that where the NVI was



in a persistent rising trend there was a 96% probability that a bull market was in progress. When the NVI was in a bear trend, there was only a 47% chance that a bull market was in progress. In other words, since there is a normal tendency for the NVI to decline, when the NVI is declining it is not saying too much. BUT, when the NVI (in one of those rare periods) is in a bull trend, the odds are overwhelming that a bull market is in progress.

I am including my chart of the weekly Dow closing along with the weekly NVI and the weekly A-D Ratio. The chart shows that all during 1986 right up to the present the NVI has been in an extraordinary rising trend. In fact, the NVI action has been so bullish that recently I started to distrust my own calculations. So a few weeks ago I called Norm Fosback in Florida to check with him on his NVI figures. "Yes," said Norm, "his NVI statistics checked with mine." In fact, in the last issue of the Market Logic report, Fosback notes that the NVI is in a "super-super-super bullish rising trend."

I feel that the action of the NVI is extremely significant here. Firstly, because very few people know about it or follow it. Secondly, because the NVI is in such a powerful bullish trend. And finally, because the NVI is one of the best and most reliable tools we have to confirm the continued existence of a primary bull market.

THE PLAYERS: New dynamics are now working in the stock market, and very few people understand them. One who does is my old friend, Robert Powers, president of Robert S. Powers Investment Service. I am presenting an edited piece (my editing) from Bob's Oct. 5 report. ... *The dramatic September 11-12 smash began with a sharp decline in the futures contracts on the S&P Composite, as a number of leading stock market analysts turned bearish. When the S&P futures dropped to a discount to the actual S&P Composite, PROGRAM TRADERS sold baskets of S&P type stocks and simultaneously bought the S&P futures, thereby driving down the level of stocks. The program traders were thus arbitraging in order to lock in a risk-free return, based on the spread between the futures and the actual shares.*

Many pensions and trusts invest in INDEX FUNDS. These index funds hold large amounts of stocks which mirror the S&P 500. When S&P futures become undervalued vs. the actual S&P Composite, the index funds find it profitable to sell their stocks and replace them with futures contracts. Over the recent past the index funds have been doing this with a vengeance.

Recently, a new player has entered the Wall Street picture. This is the PORTFOLIO INSURERS. The portfolio insurers, unlike the previous two, are concerned with the level of the S&P Composite. The insurers (whose clients are usually large pension funds) insure their customers by selling S&P futures contracts when they believe the market is heading lower. In a declining market the insurers will sell futures contracts (in order to insure their clients' portfolios) even though the futures may be selling at a discount from the actuals.

A LARGE SHORT POSITON HAS NOW BEEN CREATED. The portfolio insurers, index funds and program traders are now short billions of dollars worth of common stocks. The shorts will be covered by the program traders and index funds when a reasonable premium over the spot price returns to the futures contracts. This will set off a huge upside explosion in stock prices. Once this explosion occurs, the portfolio insurers will begin to buy back the futures contracts that they sold. This will cause a large premium to develop in the futures contracts, which will put program traders in action selling futures and buying stocks -- driving prices even higher. The only losers in this process will be the portfolio insurers, who will constantly be buying high and selling low.

Russell notes: In a bull market (which this is), the PRESSURE will always, in due time, be to the UPSIDE. When this upside pressure becomes too much for the huge short position to stand, the short position will start to unwind, and prices will head relentlessly higher. This is what we will probably witness before the year is out.

For a copy of Bob's sophisticated and valuable report, write to Robert S. Powers Investment Service, 450 B St., Suite 760, San Diego, CA 92101.

AUGUST 1995: I've been a bull for so long I thought, just for the sake of equilibrium, I should check my bullishness and climb on the other side of the fence. Here is a very serious look (courtesy of the infallible Russell crystal ball) at the year 1995.

It was August of 1995 when what was left of the old stock market analyst bunch got together to kick around what had happened. It was really like a meeting of war veterans. Hell, hadn't we been through the economic equivalent of a combined World War I and II? It sure felt that way. Anyway, we got together in LA at the rickety old Century Plaza Hotel (we met there mainly because times were super-tough, and we got a real good deal at the Plaza -- I think they gave us a group rate of $19 a night for each of us with a full breakfast thrown in).

I remember that 10 of us met in the Plaza coffee shop. Bob Prechter was there with his usual armful of well-worn charts. I couldn't resist kidding him: "Whatever happened to that last deceptive Elliott Wave, Robert? How come you didn't do a switcheroo when the Dow hit 2,900 in late 1988 -- just before it started heading down?"

Bob smiled, "Listen, Elliott failed for the same reason that your nutty Dow Theory failed. None of us really believed China was coming out with a $1,700 car, and none of us saw the Japanese bailing out of Treasuries on such a massive scale. Besides, I did get some kind of warning sell signal in early '88, but like a fool I kept waiting for Dow 3,600."

"Yeah," I reminisced. "Those were the days. Even the non-callable 21% US Treasuries didn't keep the Japanese buying our debt. But, hell, by 1988 the Japanese owned 23% of the US anyway. Buying those T-bonds would have been like buying back their own investments. I guess the Japanese are no different than anyone else.

Panic is panic, and they were so frozen with fear you could see icicles forming on the roof of the Tokyo exchange"

At that point Marty Zweig looked up from his frayed New York Times (he saved money by reading yesterday's paper.) "Listen, I hope you guys aren't going to spend all day kicking around the problems of 10 years ago. I'm more interested in whether the Dow's ever going to climb over 200 again. I mean I'm beginning to dream about rallies and mini-bull markets. And I'll tell you something else. I'm not so sure this nightclub idea of ours is a good one. And for damn sure I don't like the name."

You see, for want of something better to do, six of us ex-Wall Street analysts had pooled what cash we had left (we were still hopeful) and started a cafeteria-nightclub with the trendy name, "The Soup Kitchen." Unfortunately, we had somehow misjudged the tenor of the times. LA was a sea of patched clothes and hungry faces, and that Soup Kitchen name angered people rather than inspired them. Also, the idea of an in-house folk group entitled "Hard Times" simply added further salt to the wounds. Our brilliant nightclub was on the edge of bankruptcy, but since almost everything in LA was too, we took it as a kind of dark joke. The further joke was that the collection agency (which was dunning us daily) was on the verge of bankruptcy itself.

"You know," mused Bob Nurock (he was one of the last of the old gang, along with Wall Street Week program, to throw in the towel), "I really think what precipitated 'The Great Disaster' was when the junk bond index broke in half in early '88. I'll never forget it; the index was 1200 in January and by late-February it was 590. Then when the index collapsed to 375 a month later I knew we were hearing the bell ringing for the bitter end. I sold half my stocks on the basis of the first junk bond break. I should have sold everything, but it all seemed so bizarre, so unreal. And then, the stock market did appear to hold up pretty well -- at least for a while." I thought I detected a bit of moisture around the corner of Bob's eyes.

Ian McAvity (he had been bearish for three years before the crash, but had turned neutral near the end) sucked on his pipe and stared at the ceiling. "It was the funds that did it, those rotten, greedy, proliferating mutual funds. When they called a moratorium and issued IOUs for 1,700 different funds, the public went into total shock. From then on, if you even mentioned Wall Street you started a street riot. In my opinion, they should have outlawed any new funds around 1986, and I said so in my report of July 12 of that year." Ian put the pipe down and sipped thoughtfully on a sloe gin fizz.

Harry Schultz dug his spoon into a murky looking orange slurpy and half-smiled (yeah, Harry was finally back in the states along with a dozen other hard money guys). When the whole precious metals complex caved in along with everything else, the hard money people joined us down-and-outers. Stocks, bonds, gold, platinum, land prices, real estate, it had all gone down the drain with one final, hideous whoosh. The only things of value that were left were canned goods, pistols and rifles, torn copies of Howard Ruff's survival manuals, and packs of obsolete greenbacks (which we used, by the way, as building bricks). And of course, the people who came out best on the whole thing were a handful of solvent (but well-armed) farmers. Those guys at least had food on the table.

Harry was sobbing now. "I kept warning my readers about the debt. I kept telling people that we were giving away our freedom. But nobody gave a damn. It was like everyone wanted to take over somebody else or do a leveraged buyout on the next guy. The country stopped producing anything but more lawyers, investment bankers and kids who knew how to eat hamburgers. You had to be blind not to see that we were on the edge of the cliff."

"OK," Lou Rukeyser added, "but let's face it, most of us were blind. I guess what fooled us all was the market itself. I mean, do you remember when Ikado-dai took over Merrill, Lynch and then merged it with Hutton and Salomon. And six months later the whole crazy conglomerate filed for Chapter ll. Chapter 11, actually, they should have filed for the looney bin! I just couldn't believe it when Merrill-Hut-Sal crashed from over 1,000 down to 2 3/8s. And fool that I was, I owned about 500 shares of the nutty thing myself."

"Hey, what is this, a funeral dirge?" piped Joe Granville. "All we're doing is talking about normal cycles. This whole current down-cycle isn't going to be any worse than 1929-32." (Of course it already was, but Joe, a true contrarian, was wearing his optimist's hat now.) "You guys can weep and wring your hands, but I'll tell you what I'm going to do. I'm thinking seriously of starting another investment letter. I really believe the time is about right. I've even got a name for it. I'm going to call it 'The Rainbow Reader', and I'm going to promote it with sky-writing and by distributing leaflets on car windshields down in the Wall Street district."

I guess a few years ago we would have laughed at Joe, but the truth is that we were all so tired of the blasted depression that our eyes brightened at the sound of Joe's new-found optimism. "What the devil," I thought to myself, "maybe I'll try a newsletter again. Let's see, for a name -- how about "Wall Street Rises" or "Ascension." Well, heck, the name's no problem. The problem is will there ever be a real bull market again?" That very afternoon the day the Dow tested the 1932 low and held -- at 43.15. I was beginning to see some hope at last.

NOTES & QUOTES: When I got out of college back in 1945 my first job was with the art department of an advertising agency (advertising was the glamour business of the late-1940s, don't ask me why). After a year of that, I went into the textile business as a textile designer. But those were primitive days in designing. Today top-name designers make a fortune, and many of them do it via royalties (i.e., lending their name to various products).

Ralph Lauren (according to W magazine) has an income of roughly $15 to $20 million a year, and he has a net worth estimated at $300 million. Oscar de la Renta could earn $5 million this year. Observers believe Calvin Klein is now worth around $100 million. Bill Blass is reputed to be worth $30 to $40 million. Liz Claiborne was paid $625,000 in salary and bonus, but stock in her company in mid-September was worth $70 million (her husband owns more stock then she does). Halston sold his business in 1982 for $12 million, and he still collects a salary estimated at $1.2 million a year. ... I guess I should have stayed in the business.

* *

Speaking of big bucks, the new Forbes 400 list of the "richest Americans" is out. La Jolla is a small town, but nobody ever called it a depressed area. Four of the richest Americans live here, and I include the list below. Three of the four are women and all three women inherited their wealth. The fourth, Larry Lawrence, I've known for 25 years, and aside from a few wrinkles he hasn't changed much. Larry's listed with assets of only $180 million, so he's the poor boy of the group.

Cargill family: James R., 63, Minneapolis, Minn.; sister Margaret, 66, La Jolla, Calif.; Cargill Inc., $630M together.

Copley, Helen K., 63, La Jolla, Calif., publishing, $450M.

Kroc, Joan, 58, La Jolla, Calif., inheritance (McDonald's Corp.), $640M.

Lawrence, M. Larry, 60, San Diego and elsewhere, real estate, $180M.

* *

The new "cash cows" for the Wall Street brokerage houses are the house-run mutual funds. The management fees brought in by these funds has been a huge plus in their earnings. Examples: Merrill Lynch has $61 billion in assets under management earning them over $180 million a year in fees. Hutton's estimated $17 million in management fees represented more than half its $29 million in earnings for the 12 months ending in June. Dean Witter with $27 billion in fund assets earned $63 million in management fees. Prudential-Bache with $16 billion in fund assets earned $55 million

in management fees. Shearson Lehman with $13 billion in managed assets earned $29 million on those assets. So if you're wondering why your brokerage firm is starting up a new fund a week, you can stop wondering. The story is in the numbers.

* *

Is the debt of the Third World nations worth anything? Sure it is, and there is a big secondary market in this "international junk debt." Here are the latest figures (from the Oct. 7 WSJ) on the value of the third world debt. By the way, American banks carry this junk debt at face value (100 cents on the dollar) on their books.

Foreign Debt Prices

(Cents per dollar of book value)

COUNTRY	BID PRICE	OFFER PRICE
Argentina	65	67
Brazil	74	76
Chile	66	69
Ecuador	62	66
Mexico	58	62
Nigeria	55	60
Peru	20	24
Philippines	57	62
Poland	50	53
Venezuela	75	77

NOTE: Prices are for direct government loans

Source: Salomon Brothers and Merrill Lynch by the Federal Deposit Insurance Corp.

* *

"Run Silent, Run Costly," that's the caption for a terrifying article about the cost overruns on the Navy's submarine program. The article appeared in the Oct. 13 issue of the Washington Post National Weekly (which is a hell of a good weekly paper for $39 a year, 1150 15th St., NW, Wash, DC 20071). The rest of the Post caption reads, "The US Navy's nuclear attack submarines, built to inadequate specifications in a mismanaged shipyard at vastly inflated prices, are no match for their Soviet rivals. Patrick E. Tyler tells why Admiral Hyman Rickover ordered these outmoded vessels, and how General Dynamics made money on them." If you read the story, you'll know why I call the article terrifying. It's terrifying to learn where our hard-earned tax money goes -- or at least what our federal deficits are paying for.

* *

NYC condo prices would shock out–of-towners: one bedroom apartments can easily cost $350,000 and million-dollar apartments are now commonplace. In an attempt to bring prices down, builders are now designing smaller condos. A new building called the Bentley on 30th and Third Ave. has a 7 by 7 windowless kitchen and a bedroom that is 10 by 12 (price tag $200,000). It's a tiny apartment at a fat price. Said the architect, "People are using housing for different purposes today. It's not shelter. People are coming through for a few hours a day. They entertain outside — they're using the city as their living room." States another architect, "Today's woman doesn't cook. All she needs is a freezer and a microwave." New York, anyone?

* *

The Texas banks are generally in bad shape. Here are some recent quotes. "Investing in Texas banks right now is like playing Russian Roulette" (C.J. Lawrence). And from Equity Research Associates: "An increase in oil prices wouldn't buy these banks any time. The dominant problem is real estate. Right now, Texas is staring at one of the major real estate crises of this century, and the banks are sitting in the middle of it, with huge loans outstanding." Finally, Morgan Stanley reports that of the seven institutions they follow, only two stand to make a profit this year: Republicbank and Texas Commerce Bancshares. Interestingly, the stock of Texas Commerce is now turning up in relative strength. It could be that the market has discounted the worst.

* *

Land prices in Tokyo are up 22% this year, with downtown Tokyo land going for $15,000 per square foot. Downtown San Diego (which I think is a coming area) now sells for $150 per foot. San Diego (which boasts the best climate of any city in the US) is now the second largest city in California and the eighth largest (in population) city in the US. My guess is that by the turn of the century San Diego could be the fourth or fifth largest city in the nation.

* *

I dropped into a local electronics retailer last week, and the predominance of Japanese products was absolutely mind-blowing. I bought a Sony 8mm camcorder, and it's a terrific product (weighs less than three pounds, and takes 2 1/2 hours of crystal clear color TV sound movies). But ponder this: American chip makers have lost half a billion dollars over the past two years; over the past five years US chip makers have laid off 65,000 workers.

* *

Housing: Inflation may not be a factor today, but the price of new homes has risen over the past few months at a 25% annualized rate. The price of a new home in August was 15% above the year-ago price!

* *

Now that the new tax bill is just about law, the comments are coming out of the wall. Fortune magazine thinks there'll be so many revisions to the bill that they're talking about 1987 as the year of the next tax bill! How does the public like the bill? The public really doesn't have any idea of what the whole thing is about. But this cartoon (by Wasserman) pretty much captures the public's attitude toward the bill.

NOW THAT WE'VE GOT OUR FIRST PAYCHECKS WITH THE NEW TAX RATE
WHAT ARE WE SUPPOSED TO DO WITH THE EXTRA MONEY—
SAVE IT, INVEST IT OR SPEND IT?
FIND IT

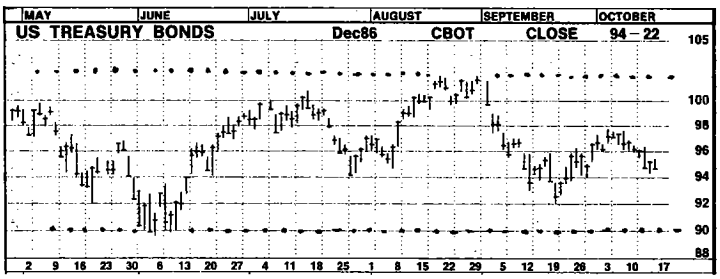
Who do you follow? Or why Russell follows the market. From the same Oct. 13 WSJ article:

> David A. Levine, chief economist of Sanford C. Bernstein & Co., foresees an economic boom. In a recent interview on The Wall Street Journal Report, a weekly television program, Mr. Levine predicted that the economy "probably will grow between 6% and 8% at an annual rate over the next three or four quarters." That, in turn, will lead to "much higher" interest rates over the next year, he said.
>
> A. Gary Shilling, who heads an economic consulting and investment stragegy firm bearing his name, expects the economy to "muddle along" for the next few months, with a "strong likelihood" of a recession sometime next year. As the economy slumps, interest rates will tumble, he said. He expects yields on 30-year Treasury bonds to drop to "between 4% and 5% sometime in 1987 or the following year."

* *

Congress's late last-minute treatment of the federal deficit was a disgrace and a sham. It was clear that Congress was bluffing when they counted an expected $11 billion dollar revenue increase from the new tax bill as part of their deficit reduction program (do you believe that!). How did Congress get away with doing literally

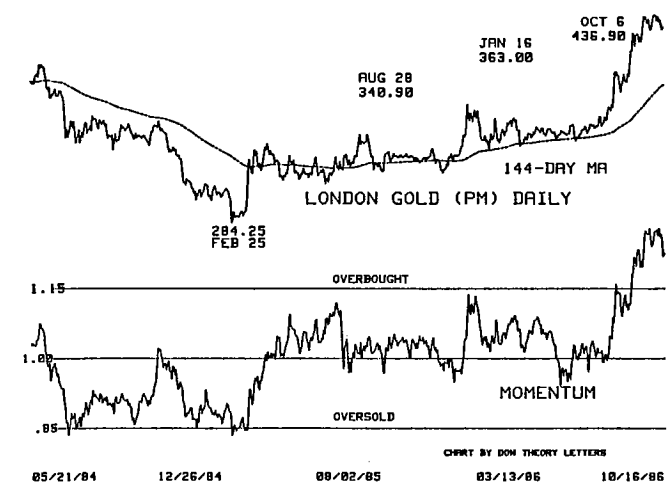
nothing on the near-crisis problem of the federal deficit? Easy, they got the nation looking in another direction, and the direction was the "national drug problem." Mr. Reagan announced that this was our new priority national emergency, and an omnibus drug bill was rushed through Congress. Evidently, in an election year, neither the president nor Congress wants to cut anything from the budget so the drug problem got the front page (of course, the drug problem has been around for years, but the current headlines about "crack" (a new form of cocaine) allowed our guys in Washington to get away with this latest caper).



RATES: I've been saying all along that the bonds (and therefore long-term interest rates) are locked into a trading range. The trading range shows on this chart of the December T-bond contract. For the last half year the T-bonds have been fluctuating between 104 and 90, and now the bonds have sunk into the lower part of this range. I would expect support for the bonds at 92 and major support at 90. Lately, the muni bonds have been outperforming the Treasuries, as well they should. Remember this: the new tax bill may promise 28% to 33% top rates, but tax rates, unlike diamonds, aren't "forever." And muni bonds are one of the few items to come out of "tax reform" unscathed.

PRECIOUS METALS: With nation after nation coming out with their own gold coins, there is a smell of incipient gold fever in the air. And the fever has been hitting US miners. A number of base metal mines are now branching out into more profitable gold. Furthermore, approximately 45 new US gold mines will come on line this year. It is estimated that 3 million ounces of gold have been produced in the US in 1986, the most since 1942 when the majority of mines were closed by federal orders during WW II. But new US production alone does not tell the story. New and old mines are currently being worked in Australia, New Guinea, the Solomon Islands, the Philippines and Indonesia. It's a world gold phenomenon. Nevertheless, S. Africa still produces 55% of the world's gold with Russia a distant second.

In the last Letter I showed how the gold price had moved ahead of itself and that therefore gold was overdue for a correction. The correction is currently underway. The first chart on this page shows the gold price still well above its 144-day moving average (which now stands at 383). So it is not at all surprising that gold is now moving down (correcting) toward its moving average.



The second chart illustrates a rule that I have talked about for years. True gold bull markets only occur when gold's relative strength (i.e., gold's price action measured against common stocks) is in a rising trend. As you can see on this daily chart, the ratio of gold to the S&P 500 Composite took a mighty leap over the last few months. We are witnessing here the best relative strength for gold in two years. What I want to see now is whether gold RS can establish an EXTENDED rising trend or whether gold RS simply recorded a deceptive upside pop over the past few months.

Note that the moving average (dotted line) for gold's RS ratio has now turned sharply higher. The test will be to see whether the moving average can continue to chart an upward path -- the opposite of the extended downward path of the moving average since 1984.

As I've stated so many times before, the key to survival during the rest of the 1980s and beyond is going to be DIVERSIFICATION. One key element of a diversification program is gold -- real money. Therefore continue to buy gold coins, preferably on a monthly fixed-dollar basis. If the price of gold goes up, you're a hero. If the price of gold goes down, you get more gold for your money. Ultimately, "gold fever" will arrive. It may be a year or five years -- but it will arrive.

LIVE --ON YOUR TV SET: I'll be on Financial News Network on November 6 at 4:30 PM NYC time (1:30 PM California time). And for the first time in 1986, I'll be wearing a necktie. If you have cable TV and some spare time, take a look.

LATE NOTES: Last week the D-J Transportation Average rallied to a new record high of 836.13. The new Transport high was not confirmed by the reluctant Industrial Average. Nevertheless, the Industrials have been inching up, and they are currently about 70 points ABOVE their September 29 low of 1755.20. The Transports are a fat 114 points ABOVE their own comparable low of 709.13. It would therefore take an important new decline in order for both Averages to break BOTH of those lows (i.e., 1755.20 and 709.13) -- thereby turning the primary trend bearish.

I can't emphasize strongly enough that the most important single piece of information for the investor is a knowledge of the DIRECTION of the great primary trend of the market. Secondly, it is just as important to realize that a trend, once in progress, REMAINS IN FORCE UNTIL PROVED OTHERWISE. The trend of this market was last confirmed as bullish, and no action so far has reversed the bullish designation. Finally, we might remember that bull markets ultimately resolve themselves to the upside -- but in their own good time.

Confirming my negative volume studies, Norm Fosback last week noted that 60% of insiders are now buyng -- twice the normal percentage, and this is bullish. Only three times in the last five years did insiders buy at this rate, and in each case the market moved higher.

NEXT MAILING: Nov. 5